Executive Summary

Despite progress in addressing key fiscal weaknesses in many countries, the global fiscal environment remains subject to a high degree of risk. Within the euro area, many countries have made good progress in reducing high deficits and specifying medium-term plans and have committed to enhancing fiscal institutions. Nevertheless, borrowing spreads have risen significantly in larger economies, including Italy and Spain, showing that market sentiment can change abruptly. In Japan and the United States, progress in defining and implementing fiscal adjustment plans has been more limited, but interest rates remain at historically low levels. In the United States, although a last-minute agreement to lift the debt ceiling was reached, the political impasse that preceded the deal illustrates the significant challenges to implementing fiscal adjustment going forward, reflected in a downgrade by one rating agency. Among emerging economies, where the needed medium-term fiscal adjustment is generally lower, the fiscal stance is nevertheless insufficiently tight in some cases in view of inflationary pressures and rapid growth, fueled in part by strong capital inflows.

Overall, significant policy challenges remain in advanced, emerging, and low-income economies and must be faced in an environment in which downside risks to growth have increased. The appropriate pace of adjustment in the short run will depend, for each country, on the intensity of the market pressure it confronts, the magnitude of the risks to growth it faces, and the credibility of its medium-term program. In this respect, strengthening medium-term plans and maintaining clear communication are critical to ensuring credibility and avoiding the possibility that the perception of fiscal risks becomes self-fulfilling, with rising interest rates and liquidity pressures eroding fundamentals. This threat cannot be ignored, and action to address it cannot be delayed.

For the euro area, the challenge is to sustain fiscal consolidation, minimize its growth fallout, and address concerns about the adequacy of crisis resolution mechanisms. Countries under severe market pressure have no option but to implement their deficit reduction plans in full and without delay. Countries with more fiscal space could choose a more back-loaded profile should the macroeconomic environment deteriorate substantially. Some of the adverse impact of fiscal adjustment on economic growth can be alleviated through reforms that shift part of the burden of taxation from labor to consumption (so-called fiscal devaluations) and through privatization. Faster growth can help accelerate fiscal consolidation, and structural reforms to boost potential growth should also therefore be part of any adjustment strategy. With respect to the crisis resolution framework, the measures announced on July 21 to increase the flexibility of the European Financial Stability Facility are welcome. Countries need to act quickly to implement them and to continue to signal clearly their willingness to take additional steps as necessary to support confidence in the euro area.

The speed and severity with which financial pressures spread in the euro area should serve as a cautionary tale to Japan and the United States. Low interest rates in Japan and the United States arise in part from structural factors that are unlikely to change rapidly, including large domestic and institutional investor bases. However, low rates also reflect the significant goodwill that the governments of Japan and the United States have earned with investors, even though many of their conventional fiscal indicators—deficits, debt ratios, and projected age-related spending growth (in the United States)—are no better than in many European countries that currently face significant market pressure. The credibility of Japan and the United States could suddenly weaken if sufficiently detailed and ambitious plans to reduce deficits and debts are not forthcoming.

- In the United States, any credible strategy will need to include entitlement reforms and higher revenues; widening tax bases by phasing out tax expenditures would be a good place

to start (see the April 2011 *Fiscal Monitor*). Defining a viable medium-term plan would allow for a more moderate pace of adjustment in 2012 than currently expected, to be offset by compensating tightening later, thus providing short-term support to the economy.

- In Japan, disaster relief and reconstruction are key short-term priorities, but this strengthens the case for a more detailed medium-term plan with objectives commensurate with the challenges the country faces. The authorities are introducing important measures with the goal of bringing the debt ratio down by the end of this decade. However, a faster adjustment that would begin reducing the debt ratio by the middle of this decade, including through further tax reforms, would be appropriate.

Emerging economies likewise face the risk of an eventual reversal of fortune. Some are taking advantage of good times to improve fiscal positions, but in several others, signs of overheating are arising. There is also a risk that elements of the positive macroeconomic environment—including capital inflows and high commodity prices for exporters—could prove temporary. Moreover, there is considerable cross-country variation in fiscal positions among emerging economies, with some facing debt ratios and gross financing needs that are close to advanced economy averages. A Fiscal Indicators Index that looks at a range of factors that have been associated with market stress shows that fiscal conditions in emerging economies are on average weakest in Europe and strongest in Asia. For all these reasons, many emerging economies need to make faster progress in strengthening fiscal fundamentals before cyclical factors or spillovers from advanced economies—which have been limited to date—turn against them. Should downside risks materialize, those emerging economies with low debt and deficits could slow the pace of consolidation to support domestic consumption.

Low-income countries made good use of fiscal buffers during the crisis, but now face the challenge of rebuilding them while addressing spending needs. High food and fuel prices have created substantial spending pressures in many low-income countries. Many of them have so far managed to address social needs without damaging their fiscal positions, but a sustainable response will require better targeting of measures and a willingness to unwind them should global prices decline. More generally, long-standing fiscal challenges in low-income countries persist, with one-third of these countries in debt distress or under high debt sustainability risk. Measures to raise potential growth will be key to addressing these conditions, with increased investment to enhance infrastructure needed in many. Improved investment processes—such as competitive and open bidding—can help maximize the productivity of capital spending.